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Reintermediation

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Abstract: The digital revolution has interrupted traditional supply chains and wholesaler relationships with manufacturers and retailers, companies are developing new methodologies to create supplier loyalty critical to control of market share. This article documents the leading strategies being utilised by companies to reassert their relevance in the value proposition for their clients and the consequences of these new business models on intellectual property law, privacy rules and influences on judicial contract interpretation. In Philip Evans and Thomas Wurster's bestselling book, *Blown to Bits* (Harvard Business Press, 1999), the authors postulated that the inverse relationship between the richness and reach of content was eliminated by the extremely low transaction costs associated with providing consumers highly rich content through digital media. Successful companies have employed reintermediation, the use of proprietary sales channels and exclusive intellectual property-protected techniques to establish brand loyalty, enforce brand exclusivity and command market-share.

Keywords: disintermediation; intellectual property; privacy; terms of service; end user license agreements; EULA; exclusivity.

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Biographical notes: Jon Garon (BA University of Minnesota; JD Columbia University School of Law) is a nationally recognised authority on intellectual property, particularly copyright law and entertainment and media law. When he joined Hamline University School of Law as Professor and Dean of the School of Law on July 1, 2003, he brought 15 years of practicing and teaching law to the Hamline community. On July 1, 2008, he returned to the Hamline faculty as Professor of Law after stepping down from his position as Dean. After a year-long sabbatical during which he will lecture internationally in locations including China and Israel, he will return to the Hamline classroom in 2009.

1 Introduction

The prevalent pattern for 21st century industry has been shaped by the changing nature of the relationship between manufacturers, distributors and consumers. Through virtual worlds, social networks and video sharing websites, the traditional pipeline of producer-to-distributor and distributor-to-consumer has re-emerged as a spider web of interrelations between manufacturer to the consumer; distributor-to-consumer and increasingly consumer-to-consumer. For many companies, the change in relationships from the 20th century reliance on regional distributors and knowledgeable resellers of

goods to a system of computer-mediated supply chains and direct-to-consumer information has radically altered the relationship between manufacturers and consumers. A few leading companies have embraced strategies to maximise this change and increase market share. The vast majority of their competitors are floundering without a clear understanding of the change.

Those embracing the new paradigm are utilising trademarks, copyright, patents and contract licensing strategies to further tilt the game in their favour. Although a few of these strategies might implicate competition law or antitrust law concerns, most of these companies are operating within the rather lax regulatory system currently in place. For the successful companies, the use of proprietary sales channels and exclusive intellectual property-protected techniques are re-emerging as critical tools to establish brand loyalty, enforce brand exclusivity and command market-share. This article documents the leading strategies being utilised by companies to reassert their relevance in the value proposition for their customers and the consequences of these new business models on intellectual property law, privacy rules and influences on judicial contract interpretation.

2 Disintermediation revisited

In October 1997, Philip Evans and Thomas Wurster published *Strategy and the New Economics of Information*¹ and later expanded the thesis for the book, *Blown to Bits*². They studied how the internet's informational flow fundamentally reshaped the relationships between consumers and retailers, and among businesses.³ Evans and Wurster posit that information is the 'glue' which holds corporate supply chains and consumer relationships together.⁴ By controlling the flow of information, companies tend to keep the supply chains linked. Unglue information content from the delivery mechanism for that content and old business alliances unravel. As the internet has allowed consumers to get information from a multiplicity of sources – including each other – the dominance of the manufacturer and supplier has dwindled. In their place, socially networked sources such as Craig's List⁵ and Angie's List⁶ provide consumers the feedback information they desire. In response, companies such as Microsoft have attempted to capture the user-generated content by hosting feedback bulletin boards in which users can provide technical assistance to other users under the auspices of the supplying manufacturer.⁷

The second phenomena identified by Evans and Wurster is the inverse relationship between 'richness' and 'reach'.⁸ *Rich* represents the size of the audience 'exchanging information'.⁹ Richness is comprised of three elements: bandwidth, customisation and interactivity.¹⁰ Rich content is highly interactive, readily customisable and able to flow in large amounts. Historically, rich content had very limited reach. A teacher in a small class had great richness but the reach was limited. As the class size grew and reach improved, the customisation decreased as did the interactivity, making larger classes less rich than smaller classes.

Before digital communications, richness and reach were inversely related, with the improvement in one coming at the cost of the other. With modern digital technology, the bandwidth limitations that made for this inverse relationship have eroded. While there remain significant costs to the creation of interactive and highly customisable content, the delivery costs are dramatically reduced with digital distribution technologies such as websites, ftp protocols, virtual worlds, video-games and peer-to-peer networks.

Moreover, since the consumer is generally paying the cost to acquire high speed capacity on their computers and portable devices, the public has further reduced the cost to the manufacturers by undertaking this burden directly.

In the decade, following the Evans and Wurster's initial article, the newspapers have faltered and the retail giants have struggled to maintain market share. The economies of scale that dictated their success have been eroded by consumer alternatives for information, pricing competition and convenience. Inevitably, these changes will influence an ever increasing array of goods and services as the richness of face-to-face communications is replicated with ubiquitous reach to a growing customer base. The audience migration to digital music and internet video highlights the importance accelerated disintermediation of media from traditional distribution channels. Today, iTunes is the largest distributor of digital music, followed by Amazon in a distant second place.¹¹ Amazon also ships physical copies, however, giving it a second revenue stream and making it a more legitimate competitor to Apple. In contrast, national retailers like Tower Records have collapsed from a lack of relevance to customers and the inability to add richness in a commodity transaction.¹²

Music sales through a digital download represents the ultimate exemplar of media disintermediation. Historically, the pricing of a musical track was related to the physical distribution of the song embodied in a medium such as an LP or a CD. A physical CD's price incorporates manufacturing, shipping, shelving and return costs. Digital distribution replaces these costs with a substantially lower expense for maintaining the online distribution channel. For music distribution, 2008 has marked the rise of iTunes to the largest channel for retail music distribution, overtaking Wal-Mart in February 2008 according to NPD Group.¹³ Apple has sold over three billion tracks since entering the market in 2003, building its lead in music distribution through the combination of its extremely popular iPod line, elegant software and proprietary formatting. Apple has become more open about its digital rights management, selling DRM-free tracks, but only after it attained dominant market supremacy.

The iTunes store, of course, has significant capital and operating costs to maintain its worldwide retail market. The scalability of the website allows the costs of maintaining a web presence to be distributed over a substantially larger user population. All steps of the middlemen were eliminated. Pressing, packaging, shipping and related businesses were dropped from the iTunes distribution. Sales of tracks utilising both iTunes and traditional stores continue to have the costs associated with package design and album content, but artists may choose to release singles, avoiding these costs entirely.

Traditional record store retailers can no longer provide the richness which kept them competitive. Although, the local record store provides a highly interactive and customisable experience, it pales in comparison to the breadth of content available on iTunes and the depth of knowledge available through a combination of iTunes and music-related social networks on the internet. Niche marketers can overcome this by narrowly targeting their audience and increasing the richness of the efforts. Ritmo Latino, for example, caters to first generation US Hispanics. According to its owner, 'It is not that we open a general [music] store and want to capture some of the Hispanic people... [w]e cater [only] to Hispanic people'.¹⁴ The strategy continues to work. Jim Donio, President of the National Association of Recording Merchandisers added, '[y]ou have to make it a place where people want to come back over and over again; you have to be part of your community'.¹⁵ Some musicians are taking the disintermediation a step further, selling tracks from their personal websites or from widgets on MySpace pages.¹⁶

Newspapers are suffering the same fate. Newspaper revenues have dropped dramatically as advertiser-funded online content has made those authorities of information fight for legitimacy with blogs and compete with each other unaided by the local monopolies available in most print markets.¹⁷ Real estate advertisers – the largest advertising category for newspapers – ‘want a direct relationship with their clients’, Borrell analyst Andrew Martin said. ‘It shows signs of disintermediating all commercial advertising for real estate’.¹⁸

3 Exclusivity as the antidote to irrelevance – the practice of reintermediation

The response to disintermediation is relevance, affinity and exclusivity.¹⁹ The use of copyright and patent can create exclusivity that serves to develop exclusive channels of distribution. Exclusivity can be achieved by contract, such as the long-term service agreements demanded by many US mobile phone companies.²⁰ But these agreements are seen as coercive by the public, eroding affinity rather than building relationships.²¹ Effective reintermediation strategy uses exclusivity to improve affinity.

Affinity built on exclusivity can be difficult to maintain. Both Apple and Microsoft, for example, have developed proprietary digital rights management systems (DRM) that are incompatible and therefore require users of their music players – iPods and Zunes, respectively – to purchase content that has only their own DRM coding. No challenges to this proprietary regime have been raised in the USA, but there were substantial complaints by European Union members against Apple for its lack of interoperability.²² Apple’s proprietary DRM system was integrated with the launch of the iPod, the iTunes software and the iTunes store. The combination created a bundled music delivery system that muscled its competitors off the consumer’s computer screen. The combination of these three elements worked astonishingly well, redefining the music business and software industry at the same time.

To soften public criticism of Apple’s proprietary Fair Play DRM software, Steven Jobs has decried the failure of DRM for music, suggesting that Apple would quit if it were not forced into unilateral disarmament. ‘Imagine a world where every online store sells DRM-free music encoded in open licensable formats. In such a world any store can sell music which is playable on all players. This is clearly the best alternative for consumers, and Apple would embrace it in a heartbeat’.²³

The sentiment expressed reflects Apple Chairman Jobs’ crying crocodile tears from his vantage point atop the digital download industry. With a dominant position in both the sales of the players and content, Apple needs to avoid the public perception as favouring proprietary or consumer-unfriendly products. Despite Jobs’ comments on DRM, Apple has always embraced a wholly proprietary strategy. It has refused to license its computer operating system, protecting 100% of the Apple software and hardware business rather than chasing a larger market share in either field. In fact, it continues to challenge third party manufacturers who attempt to make their equipment compatible with Apple’s software.²⁴

The most recent example of Google’s reintermediation strategy is called Lively,²⁵ a beta 3D virtual environment platform. Although behind Second Life, Google has a history of catching up. Moreover, the platform’s browser-based approach will allow it to insinuate itself into small and large applications – putting Google between the consumer

and the advertiser in a host of new environments. Given the ubiquity of Google, consumers tend to think of it as a utility rather than an advertising platform. Just like 'free' broadcast television, however, Google's strategy is simple: be the first choice for consumer interaction and sell that interaction to advertisers – just as newspapers filled that role in the previous century. Google's tools are not free; they are advertiser supported. Under this business model, the extension into virtual worlds represents a natural extension of its reintermediation strategy. And given the strategy, the extension into virtual worlds will grow, expand and move from a curiosity to an essential tool because Google cannot afford to allow any other advertising company to gain a foothold in a marketing sphere.

4 Reintermediation for proprietary strategies for market dominance

Reintermediation strategy utilises contracting strategies, consumer data information and structural business approaches to encourage additional steps in the consumer transaction which build an ongoing relationship between the enterprise and the consumer. A comparison of the strategies adopted by Amazon and Apple demonstrates how resellers use the legal and business tools available to redefine the consumer experience.

4.1 Amazon's reordering of the publishing industry

Amazon.com has moved the furthest to introduce its reintermediation strategy, creating an intuitive user interface which pulls consumers into the website with highly customised e-mail communications and an equally customised home page; a proprietary product distribution device and increasingly control over products sold on its platform.

The business strategy begins with the home page website, designed to shape the behaviour of its users and build a strong reliance on its information. Most of the Amazon home page provides product recommendations based on the viewing history of the consumer. Amazon uses the private data to tailor the recommendations very closely to the consumer's most recent shopping history. These recommendations tend to shorten the time a consumer must spend finding relevant products. By shortening the search time, Amazon is trying to increase the probability that the time spent online will result in a completed transaction.

Amazon also recognises that consumers have close to perfect pricing information (thanks to Google) and therefore price their products and shipping costs to be the same or below their major competitors. Amazon builds on the information provided by publishers and manufacturers with consumer reviews and aggregate consumer behaviour data. This allows a customer to see if there are other consumers choosing a competing product. At worst, this emphasises the herd mentality of the public, but at best it allows the customer to improve the reliability of his or her partial product information. The consumer does not need to learn everything about a product to make a purchase. A small amount of information combined with strong behavioural data will tell the consumer he or she is making the correct choice regarding the product.

The cumulative impact of Amazon's user interface makes the information more robust than most reference librarians can provide for their face-to-face patrons. As a result, the Amazon interaction combines universal reach with rich content of

customisable, interactive and high-bandwidth – the embodiment of Evans and Wurster's predictions.

The website interaction is just the first step in Amazon's reintermediation strategy. Amazon experienced its own iPod moment over the past year with the highly successful launch of its e-book reader Kindle.²⁶ The Kindle quickly exceeded expectations, selling out only hours after launch.²⁷ Also like Apple, Kindle uses a proprietary e-book format. Moreover, Kindle's primary selling feature further reinforces the exclusivity of distribution sought by Amazon. The machine allows a reader to contact Amazon directly from the device, without the need to synchronise on a computer, making purchases directly from the device.²⁸ The elimination of the synchronising computer makes the Kindle even more dominant than the iPod has been for music as a sole-source mediator of content.

Despite the small portion of the market in e-books, publishers are nervous about the potential impact Amazon may have. Publishing executives 'fear Amazon's still-growing power as a bookseller. Those executives note that Amazon currently sells most of its Kindle books to customers for a price well below what it pays publishers, and they anticipate that it will not be long before Amazon begins using the Kindle's popularity as a lever to demand that publishers cut prices'.²⁹ Companies are buoyed by Amazon statements that users of Kindles are not purchasing fewer print books and the device may be increasing overall title sales.³⁰ Publishers are significantly increasing the number of titles released as e-books.³¹

Amazon is growing its strategy by increasing its control on book publishing as well. In March 2008, it announced a new policy under which all print-on-demand books distributed through Amazon must be manufactured through Amazon's print on demand system.³² Using Amazon's BookSurge print-on-demand subsidiary, an author can create a book, have an e-book formatted for Kindle and have the print-on-demand catalogued and sold on Amazon.com.

Organisations such as the Author's Guild and the Independent Publishers Association have raised concerns that this will lead to unreasonable market dominance for Amazon, making other print-on-demand distributors largely redundant and likely to disappear.³³ At that point, authors are concerned that Amazon.com will use the market dominance to drop royalty rates and significantly raise production costs for these self-published authors. Amazon uses its 1-Click ordering service to promote – or demote – various suppliers as a method of pressuring its suppliers for favourable terms.³⁴

For the consumer, the Kindle and the other services move both the consumer and the author towards a relationship of extreme reliance on Amazon. Owners of Kindles will not purchase e-books elsewhere because they would lose the wireless benefits of the reader. Authors, musicians and filmmakers using Amazon's services will strongly encourage their fans to buy on Amazon, maximising the revenue for both parties. Amazon then uses this market share to reduce costs of content acquisition. For suppliers, Amazon is increasingly proprietary, but is softening this threat with a host of marketing incentives to create a positive, symbiotic relationship. For the consumer, the relationship is entirely non-exclusive, built on highly customised, interactive rich content.

Amazon influence has already stressed the business practices within the publishing industry. HarperCollins has announced a substantially new business model under which advances will be reduced, retailers will no longer be able to return unsold books and authors will be compensated with a larger share of royalties in lieu of the current guarantee system.³⁵ Under the new arrangement, the company would provide 50%

royalties in lieu of any advance.³⁶ The new imprint shifts the financial risk of publishing from the publisher to the author and retailer, mimicking the model being developed by Amazon.

The reaction to the shifting publishing market by HarperCollins reflects the marginal disruption point in the industry. If Amazon – or any combination of factors – undermines the profitability of traditional publishing, then the existing structure of author advances, publisher print runs, bookstore displays and publisher buy-backs of overruns will be wiped out by the more efficient print-on-demand and e-book model that rewards actual sales. Undoubtedly, this will result in shallower purchases by the retailer and fewer returns, threatening discount book and remainder business as well. This model will, of course, be much more efficient. It also means that there will be less incentive or funding for developing the marketability of new writers and further accelerate the decline of the publishing industry.

4.2 *Apple's continued proprietary strategy*

In comparison to Amazon's reintermediation approach, Apple has always invested in a proprietary strategy built to avoid commoditisation of its products. As IBM created and then lost the personal computing business, Apple competed from afar, never gaining significant market share but never risking the devastating commodity pricing that destroyed many of the earlier computer companies.³⁷ Apple continues to struggle to distinguish itself in the competitive computer market.

At the same time, Apple has a host of successful software products and its iPod gave the podcasting phenomenon its name. Although music and video players have become commodities, Apple continues to dominate the market with an innovative product design, unique interface and proprietary DRM. But its own success may make it difficult to continue saturating that market. The explosive extension into the mobile telephone business has placed Apple in a much more competitive, high-stakes race. Moreover, as a phone manufacturer it is forced to partner with mobile phone providers, which reduces its exclusive relationship with its clients.

Apple continues to seek the larger markets of home computers and home networks. Using the ubiquity of the iTunes software base, Apple used the semi-automated update features of its program to introduce the Apple Safari Internet browser into the Windows market. Users of iTunes found that Safari would automatically install on their computers as part of an iTunes software update unless the user unchecked an installation approval box. Whether this distribution is sufficient to gain significant market share remains to be seen, but it is unquestionably more efficient than expecting each potential user to seek out the Apple installation page to download the software.

The tying relationship between the iTunes operating software and Apple browser harkens back to the start of the disintermediation phenomenon in 1995 when Microsoft used its dominance in desktop operating systems to steal browser market share from Netscape.³⁸ Apple did not *integrate* the Safari software directly into iTunes, and thus avoided a claim of illegal tying, but by making the installation of the browser software a default action for the millions of iPod users, Apple is moving to increase consumer reliance on its software and away from both Microsoft and the other browser providers. The Safari feint is part of Apple's larger strategy to keep undermining Microsoft's hegemony over the desktop and laptop computer. Relentlessly, Apple will keep pushing

the message that if you like our music player, our phone, our browser, you should buy our laptop and desktop computers.

4.3 The battle for movies and television

The ultimate battleground for entertainment market is the home movie and television delivery industry where the cable monopoly is eroding.³⁹ The companies that can win the affinity for set-top relationships will gain a tremendous portion of advertising revenue and brand superiority. Apple joined the battle with Apple TV in 2007, but had no market impact.⁴⁰ Apple has been trying to extend its iTunes service to the home theatre for years. Steve Jobs admitted the emphasis on the home movie business. 'We've all missed. No one has succeeded yet ...'⁴¹ Sony and Microsoft each announced strategies to expand motion picture distribution directly to the consumer using their videogame stations.⁴² In the case of Microsoft, the Xbox 360 will stream Netflix's on demand movies and television shows directly from the console.⁴³ Sony's films and television programs can be transferred to a PlayStation Portable (PSP), allowing the PlayStation to compete with Apple's iPhone and iPod touch.

In the set-top battles, the difference between a proprietary strategy and a reintermediation strategy becomes clear. Like Amazon, Netflix's use of social networking builds a strong audience base, and to the extent that consumers can rely on the recommendations, it will have an important place in the living room. The arrangement with Microsoft nicely benefits both companies, increasing Netflix's reach and allowing Microsoft up from the kid's basement or out of the office and into the living room as well.

Apple cannot use its consumer electronics clout to gain command of the television set-top box because Apple has failed to translate its proprietary strategy into a reintermediation strategy. 'If my iPod is separate from my TV, then why use my iPod?' Television is associated with the Xbox or PlayStation, not the music player. Were an iPod to 'talk' with the TV, so that all the movies downloaded on the iPod were synched with the TV, then Apple would have a strategy of reintermediation. The iPods' ability to become personal playlists for any connected television would result in households with Apple TV and separate iPods for each family member. Merely having the iTunes software is not nearly enough.

5 The legal limits of reintermediation

Reintermediation relies upon customer affinity and behaviour of repeated reliance on a particular company to the exclusion of all other providers of that good or service. The exclusivity may have no legally enforceable parameters or it may be based on either exclusive dealing contracts or intellectual property protections. Exclusivity, taken to its logical extreme creates monopoly power, but as courts often point out, monopoly power is not itself illegal.⁴⁴ '[T]he challenge for an antitrust court lies in stating a general rule for distinguishing between exclusionary acts, which reduce social welfare and competitive acts, which increase it'.⁴⁵ For individual companies, the challenge is to find socially beneficial competitive acts which increase exclusivity without running afoul of legal limitations. The area in which the tension between affinity and illegality is

highest involves exclusive dealing contracts, tying relationships and interference with interoperability.

5.1 *Exclusivity in contracts to reduce portability*

When a consumer purchases a software product or enters onto many websites, the consumer is required to 'accept' the terms of an agreement written for the transaction. Such agreements have generally been found to be enforceable.⁴⁶ While these agreements are highly controversial and require that the terms are readily available contemporaneously with the transaction, they have pervaded the digital environment.⁴⁷ End user license agreements (EULA) and terms of use agreements (TOU) set the terms and conditions for access to the content of digital media.⁴⁸ These license agreements use the contractual terms to prohibit reverse engineering or modifications to the software, to make all modifications by users the property of the publisher, and to limit access to the works.⁴⁹ In *Davidson & Associates v. Jung*,⁵⁰ the Eighth Circuit Court reviewed a tightly drafted EULA and found the controls embedded in the EULA complemented the legal copyright protections, and the court upheld the agreement.⁵¹

Despite the general applicability, however, these contracts continue to come under significant judicial scrutiny. In 2007, the agreement governing the extremely popular virtual world, Second Life, was determined to be unenforceable.⁵² Second Life has grown to become the leading non-gaming virtual world platform, at least in part because of its contractual commitment to recognise the intellectual property rights of the users who create content in the medium. Avatars, designs, trademarks and other content remains the property of the author rather than being treated as a derivative work of the website that is transferred by contract to the publisher of the website. Under this policy, 'Second Life avatars may now buy, own and sell virtual goods ranging from cars to homes to slot machines'.⁵³ In turn, Second Life generates revenue based on the uses to which these assets are put. In 2006, attorney Marc Bragg purchased a property in Second Life for \$300 which gave rise to the dispute. Linden Research took back the disputed property, froze Bragg's Second Life activities, and 'effectively confiscate[d] all of the virtual property and currency that he maintained on his account with Second Life'.⁵⁴

When Bragg brought legal action, Linden moved to compel arbitration. The district court sided with Bragg. The court found the terms of service agreement (TOS or clickwrap agreement) to be both procedurally and substantively unconscionable.⁵⁵ Though procedurally unconscionable, the contract was not automatically unenforceable. Under California law, a procedurally unconscionable agreement may be enforceable 'if the substantive terms are reasonable'.⁵⁶ But courts find that when the party offering the agreement retains multiple methods of unilateral redress while offering only binding arbitration to the other party, it is an unreasonable, substantively unconscionable agreement.⁵⁷

The court also found the arbitration fee distribution and venue clauses similarly one-sided and substantively unconscionable. As a result, the agreement's arbitration provision was found not enforceable. The decision provides a significant limitation on the power of companies to contractually create exclusive dealing, because of the ubiquity that these clauses now have in clickwrap agreements involving a wide variety of software. Moreover, the ability to reach personal jurisdiction and the willingness to tie the advertising to the contractual obligations all combine to increase the accountability that publishers and website operators have to their subscribers.

Interestingly, the US courts will give the publisher wide latitude to claim the intellectual property generated by users of their virtual worlds or software products as the property of the publisher, but require much greater scrutiny over quasi-judicial clauses that set out the interpretation of the contracts. These contracts make the portability of the users' intellectual property – avatars, characters and potentially music, video or writings – harder to move from one product to another. This lack of portability ties the consumer to a particular product, enforcing affinity and quasi-exclusivity. Players in these games and users of these websites have little concern so long as they remain in the environment, but will find it legally and practically challenging to use the work they have done on other platforms.

5.2 Interoperability and digital rights management

The USA has been a strong advocate of copyright law protections designed to secure digital copies from piracy. In the Digital Millennium Copyright Act, the US adopted § 1201 as codification of treaty obligations enacted in the WIPO Copyright Treaty and WIPO Performances and Phonograms Treaty.⁵⁸ Article 11 of the WIPO Copyright Treaty requires that Contracting Parties 'provide adequate legal protection and effective legal remedies against the circumvention of effective technological measures' to protect copyright.⁵⁹

What is less explicit is the extent to which interoperability must be allowed under Article 11. The parallel EU directive is rather hortatory in its statement that '[c]ompatibilty and interoperability of the different systems should be encouraged. It would be highly desirable to encourage the development of global systems'.⁶⁰ In contrast, § 1201(f) provides a specific exemption under US law for reverse engineering for the specific purpose of developing interoperability.⁶¹ Where the product also includes an EULA, however, the publisher or manufacturer can incorporate contractual provisions that eliminate the purchaser's ability to take advantage of their broader legal rights to reverse engineer. It remains uncertain whether such a contract would effectively block a legitimate competitor's attempt to utilise a competitor's product for interoperability. Instead, the fear is that the threat of such lawsuits has discouraged innovation and interoperability.

Despite the controversy created by iTunes DRM software and a flurry of legislative activity in France, the situation never resulted in a legal obligation by Apple to open its proprietary DRM.⁶² 'The European Commission does not seem to be too concerned about the lack of interoperability of iTunes. According to Charlie McCreevy, 'if consumers want a seamless system that marries the music they buy and the player they listen to – why shouldn't they have it, especially if it doesn't distort the market or prevent others from entering? If people don't like one product or approach, they will vote with their wallets and go elsewhere'.⁶³ This attitude reinforces the reintermediation strategies of multinational companies and it may significantly underestimate the cumulative effect of the various intermediation strategies on the public.

5.3 Tying agreements and bundling

Another of the strategies used to build affinity into exclusivity is the practice of tying or bundling products together. The practice of offering discounts on bundled products or services may simply pass efficiencies of scale along to the consumer or it may use the

market leverage of one product to promote the second product. Under US law, to be illegal, the tying arrangement requires the government to establish four elements: 'first, two separate products must exist; second, the defendant directly or practically must condition the sale of the tying product on the purchase of the tied product; third, the defendant must enjoy leveraging power in the tying product's market; and fourth, the practice of tying must foreclose a substantial amount of competition in the tied product's market'.⁶⁴ Articles 81 and 82 of the Maastricht Treaty⁶⁵ provide the anti-tying protections to the European Union from unrestrained tying relationships. Article 81 specifically addresses tying by prohibiting agreements 'which make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts'.⁶⁶

In the arena of software integration, there has been a great focus on the separation of products, such as the integration of Microsoft's web browser⁶⁷ or music player,⁶⁸ but the separability of bundled products may be less difficult to identify in other contexts. In the USA, Microsoft's tying activities were not ultimately reviewed.⁶⁹ The consent decree allowed for third party products such as browsers and media players, but did not remove Microsoft's products. In Europe, greater culpability was found, but the results were substantially the same.⁷⁰ The direct and indirect tying created by Apple's refusal to provide interoperability or by Amazon by requiring print-on-demand books be created using its subsidiary provide more recent examples of the tying activity that will engender customer exclusivity but not trigger antitrust or competition law violations.

If Apple gains sufficient market power in the defined market of music sales, then the refusal to provide interoperability could run afoul of even US law. The comments made by Steve Jobs regarding the futility of selling DRM-protected music will reinforce the notion that there is not a legitimate pro-competitive reason for creating the restriction. Applying these rules more generally, anti-tying legislation provides only marginal protection for the consumer. The US notion of economic efficiency has moved well beyond fostering new markets and provide companies focused on exclusivity strategies wide latitude.⁷¹ The European model is somewhat more protective, but the disparate treatment of Apple and Microsoft suggest that less difference between the two approaches in terms of actual prohibition of corporate conduct.

5.4 Privacy and data protection

The approach to US and European privacy protection is far more divergent than it is for competition law or copyright. The USA protects only defined categories of data, such as student privacy,⁷² financial services⁷³ and healthcare,⁷⁴ while providing government access under a broad array of federal laws.⁷⁵ In contrast, Europe has a much broader protection for data protection⁷⁶ which specifies the nature of the uses for which such data can be used⁷⁷ and limitations on the scope of data collection.⁷⁸

For purposes of a reintermediation strategy, the lack of systemic processes allows US data aggregators and companies to aggressively cross-tabulate the information about customers and visitors to its websites. The US companies do not have to specify the reasons for collecting or sharing most consumer data. Unless the user is required to provide data from a protected category such as healthcare, financial, the company can broadly market the consumer data. US data aggregators, therefore, have a much greater opportunity to use the mined data to gain the affinity of the customer. The European

directives are much more demanding on the companies collecting the data, but this does not necessarily mean that it will greatly diminish the ability of the companies that collect the data to utilise that data. As demonstrated by companies such as Amazon and Netflix, customers are willing to give their consent to allow use of data and are willing to actively supply the data. Netflix asks consumers to rate movies to improve Netflix recommendations, and users readily provide the information. Provided the consumer has an affinity for the company collecting the data, the greater regulatory framework required outside the USA creates only a modest barrier.

Whether in the USA or Europe, therefore, the companies which stand the best opportunity to meet their privacy obligations and provide the greatest consumer service are those that utilise their own data to provide suggestions to their customers. By keeping the data internally, the company is much more likely to be able to acquire the necessary unambiguous consent required. The customer who chose to deal with the company is also likely to understand the need for the company to use the data. Netflix provides an excellent example. By requesting that customers rate all films for the purpose of improving recommendations, it is making clear to the customer that the rating data is being used to shape the information provided back to the consumer. The heightened consent obligation actually create an incentive for corporations to engage their customers directly, rather than use intermediaries and risk a loss of access to the information provided by those interactions.

5.5 Concerns over the cumulative effect of on consumer rights

The ultimate legal concern from reintermediation practices flow from the intersection of DRM, contracting practices, bundling arrangements and data use agreements on consumer choice. By integrating these tools, companies can build an effective reintermediation strategy, but they can also significantly limit the protections traditionally afforded to consumers by national law. For example, Sony tested the limits of public tolerance when it shipped music CDs with embedded software designed to create DRM controls on the listener's computer.⁷⁹ The software limited the ability of the consumer to rip the music to other formats by adding root kit software and unintentionally adding vulnerability to the computer's security.⁸⁰ The Federal Trade Commission action was based on failure to inform the consumer rather than any public policy prohibition of the practice.⁸¹ This approach was sufficient to stop the potentially predatory practices of Sony but also provides manufacturers the explanation of how to impose additional limitations on their customers.

Courts and legislative bodies must recognise that the various components of consumer controls must be viewed in concert rather than in isolation. In some situations, US courts are beginning to recognise this need. When a manufacturer attempted to use DRM to tie garage door accessories to its garage doors, barring competitors from building compatible products,⁸² the court recognised the need to limit DRM to the underlying copyright infringement.⁸³ Section 1201 does not 'divest the public of the property rights that the Copyright Act has long granted to the public'.⁸⁴ The risk to consumers of media products has not gone unnoticed. '[I]nformation consumers suffer from further vulnerabilities that require even stronger protection'.⁸⁵

The recognition that a clickwrap agreement may be procedurally unconscionable and therefore enforceable only if fundamentally fair provides a balanced approach and increased judicial scrutiny. Such contracts should be reviewed carefully to assure that

legal consumer protections – not just arbitration clauses – remain protected. The consumer protection policies must take into account the reintermediation strategies of the companies, recognise the concerted intersection of copyright, contract and bundling practices, and address both the individual concerns and the synergistic impact of these practices. Just as the synergies make for stronger reintermediation strategies, the synergies must be reviewed for their anti-competitive impact and undue burdens on consumers.

6 Conclusions

For better or worse, companies will learn from the examples set by Amazon, Apple, Microsoft and Google to develop more comprehensive reintermediation strategies. These companies will begin to understand that the internet provides ample tools for direct communication with the consumer and that traditional supply chains are irrelevant. The leaders at reintermediation have looked beyond the physical distribution of their products to identify opportunities to expand both richness and reach, significantly increasing the relevance of these companies to their customers. In each case, these companies have adopted reintermediation strategies focused on creating an essential role for the business beyond serving as a source of the product or service. By utilising restrictive end user license agreements, proprietary digital rights management systems and taking steps to discourage interoperability, these companies make it harder for an existing customer to leave. At the same time, these companies use consumer data information and structural business approaches to improve customer satisfaction and enhance customer support. As such, the customer may be benefiting from these activities and prefer companies with robust reintermediation strategies because those are the companies that value customers. Dangers also exist, so the cumulative effect of the reintermediation strategies may require greater attention to consumer protection and the implications of anticompetitive conduct based on the intersection of the various reintermediation techniques.

While reintermediation is predominantly a business strategy designed to overcome the pressures of internet commoditisation and digital piracy, the practice will continue influencing the development of contract interpretation, privacy policy and intellectual property law. Companies will push to increase the flexibility with which they can employ these strategies. The music industry has experienced much of this transition; the publishing and motion picture industries are not far behind. Inevitably, these changes will influence the distribution of goods and services in every transaction as the richness of face-to-face communications is replicated with ubiquitous reach to every potential customer in the world.

Notes

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